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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-439

LEHMAN BROTHERS,

Petitioner,

v.

JACOB SCHEIN; MARVIN H. SCHEIN; ANTONE F. GREGORIO; LUM'S INC.; MELVIN CHASEN; BENJAMIN SIMON; INVESTORS DIVERSIFIED SERVICES, INC.; INVESTORS VARIABLE PAYMENT FUND, INC.; IDS NEW DIMENSIONS FUND, INC.; EUGENE S. SIT; AND JAMES R. JUNDT,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER LEHMAN BROTHERS

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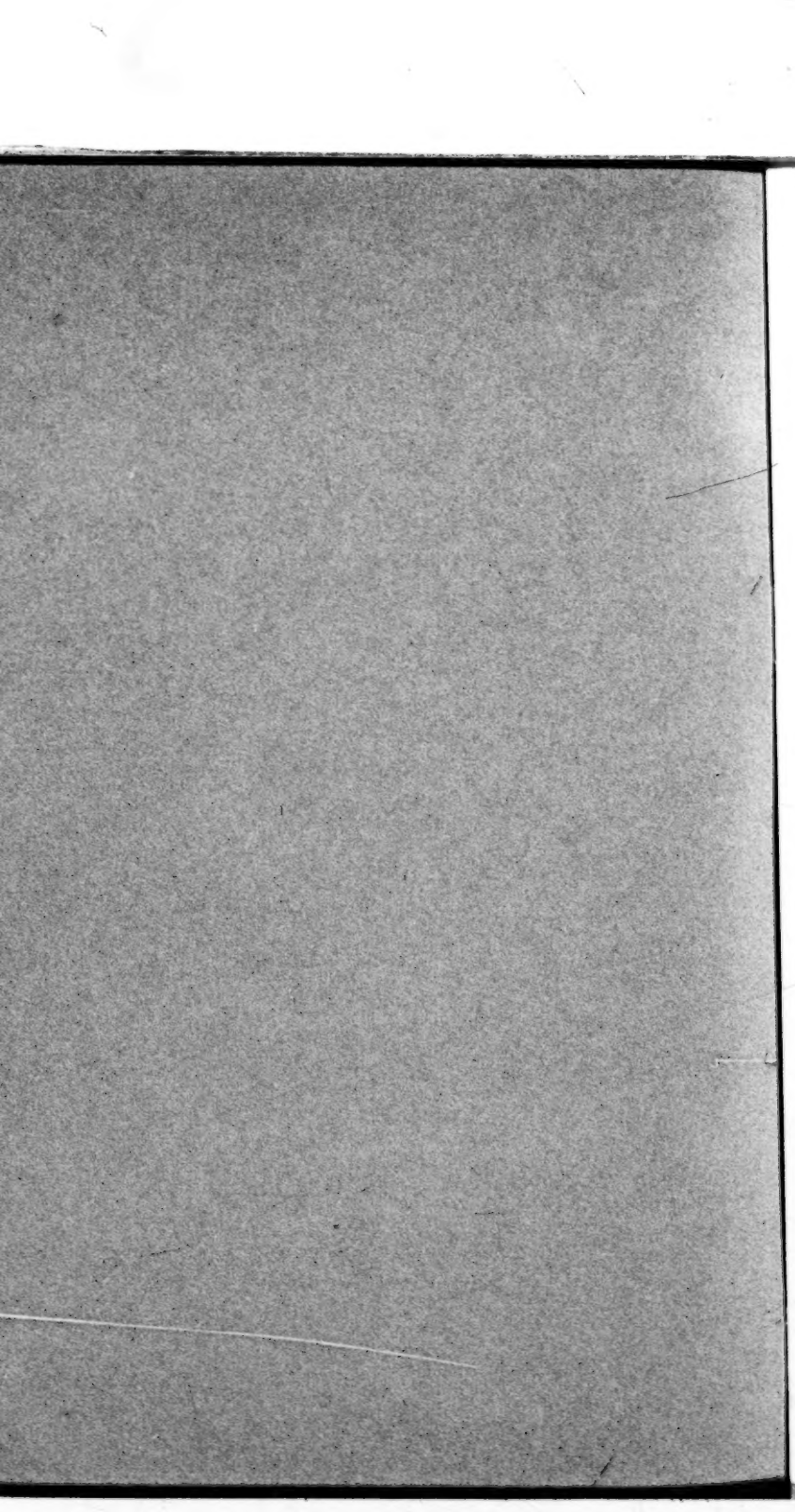
March 15, 1974



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REPLY BRIEF FOR PETITIONER LEHMAN BROTHERS

Petitioner Lehman Brothers respectfully submits this brief in reply to contentions made in the brief of respondents Schein and Gregorio.

POINT I

Availability of certification renders unsupportable the refusal of the court below to permit Florida to declare its own public policy.

A. Respondents have failed to address themselves to the issue before this Court.

Respondents recognize, as they must, that this Court has directed the referral of questions of state law to state courts in a variety of circumstances (R. Br. 16-17), but they refuse

to examine the decision below in the light of such precedents to determine whether similar action was necessary here. Instead, they rely on the argument that the court below "did not express an inability to determine the state law question at issue and in fact determined it" (R. Br. 23n.), assert without support that the court below "scrupulously performed its duty under *Erie*" (R. Br. 20n.), and repeatedly tell this Court that the Second Circuit decision "simply" concerns "a remedy under Florida common law" (R. Br. 10, 17, 18, 20). The central issue, they claim, does not call for a determination of Florida public policy and presents no such special need for a correct result as would call for abstention. Certification of such an issue, respondents claim, would "undermine the principles of diversity jurisdiction" (R. Br. 29).

To explain their total refusal to discuss the implications of the ruling below, respondents argue that this Court addressed the grant of the writ only to the question of the necessity for certification. But the specific question posed by the Court only reflects the practical limits of its concern, in general, with the merits of state law issues on which this Court lacks final authority. Such limits make plain the need for correct decisions of important state law issues in the lower federal courts. For such decisions are in practice not reviewable, and if they are not faithful to the state law, the principles of diversity jurisdiction are truly undermined. The certification procedure here at issue was developed to ensure that such decisions are correct, and had respondents examined the crucial issue in this case, they would have been forced to concede that certification was clearly required here.

This Court's prior rulings demonstrate that the need to refer an issue to a state court depends greatly upon the novelty of the issue. *Kaiser Steel Corp.* v. *W. S. Ranch Co.*, 391 U.S. 593 (1968). Respondents do not attempt to show that

the "fiduciary liability" theory adopted below is drawn from any common law principles expressed in Florida cases. They assert that the only issue in this case is one of "remedy". But such claim is clearly erroneous, since the doctrine invented below is no "remedy" for injured parties; instead, it awards a windfall to an undamaged entity from persons who owe it no duty. It stands conceded that the court below acted without precedent in Florida law in creating a wholly novel deterrent and punitive device.

Respondents merely dispute some of the effects of this new regulatory system. They claim that the new "Florida law" announced below, however illegitimate in its origins, will not affect existing Florida and federal policies, since such policies disfavor insider trading (R. Br. 18-20). But the novel issue which split the court below is not concern over insider trading, but rather the Florida corporation's asserted right to recover the proceeds on supposed "fiduciary" principles.

The majority position below, in directing such recovery, will have a very real impact upon the right of injured parties to recover their *actual* losses, a right respected under both Florida and federal law, see *Rogers* v. *Riddle,* 128 So.2d 409 (Fla. App.) *cert. denied,* 133 So.2d 645 (Fla. 1961); *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 154-56 (1972). *Diamond* v. *Oreamuno,* 24 N.Y.2d 494, 248 N.E.2d 910 (1969), the New York case which originated the corporate recovery concept adopted and expanded below, created new practical and jurisdictional obstacles to individual recovery (see Lehman Br. 28-31). The ruling below only generates further uncertainties with respect to multiple liability of defendants and the availa ility of reimbursements for injured parties. Commentators have so noted. See Note, 26 VAND. L. REV. 1337, 1345-46 (1973); Note, 42 FORDHAM L. REV. 211, 223-24 (1973); Note, 87 HARV. L. REV. 675, 683 n.51 (1974).

A recent writer points out, moreover, that corporate recovery does not protect the same interests as do existing doctrines applicable to insider trading, and that these different interests may conflict:

> "For this reason, the dissent was correct in criticizing the *Schein* court's heavy reliance on the federal policy against insider trading as the policy justification for the extension of fiduciary liability to tippees. State law essentially protects the corporation and strives to maintain the loyalty of fiduciaries; federal law seeks to protect the trading markets and impose duties toward other traders. In some cases, these interests conflict rather than complement one another." Note, *supra*, 87 HARV. L. REV. at 683-84 (footnotes omitted).

B. In the absence of a statutory certification procedure, this would be a proper case for abstention.

Respondents assert that *Meredith* v. *Winter Haven*, 320 U.S. 228 (1943), *McNeese* v. *Board of Education*, 373 U.S. 668 (1963), and *Propper* v. *Clark*, 337 U.S. 472 (1949), bar abstention in this case. Although it is certification, and not abstention, which is the issue before the Court, we will briefly respond to this argument.

Meredith concerned a situation opposite to the instant case. There the circuit court dismissed the case because it doubted the "state of permanence of the decided law," *Meredith* v. *Winter Haven*, 134 F.2d 202, 206 (CA5 1943), even though a recent precedent existed.[1] In reversing, this Court stated that difficulties, arising from supposedly conflicting earlier decisions, in ascertaining "what the state courts may hereafter determine the state law to be" did not "in themselves" call for abstention, emphasizing that in such situation "the rulings of the Supreme Court of Florida in the *Andrews* case must be taken as controlling

1. *Andrews* v. *Winter Haven*, 148 Fla. 144, 3 So.2d 805 (1941).

here unless it can be said with some assurance that the Florida Supreme Court will not follow them in the future. . . ." *Meredith* v. *Winter Haven, supra,* 320 U.S. at 234. In contrast, no Florida precedent supports the result below or even suggests that such result might be favored at some future time. Rather, Florida principles of fiduciary liability to corporations would exclude such result (see Lehman Br. 23, 33-34). Refusal to abstain in this case cannot be justified by reference to state precedents, and *Meredith* thus would not govern this case.

McNeese is likewise inapposite, for it did not concern abstention at all, but only exhaustion of state administrative remedies in a suit under the Civil Rights Act, 42 U.S.C. § 1983. The Court rejected exhaustion, since it was "immaterial whether [a state official's] conduct is legal or illegal as a matter of state law," *id.*, 674, and anyway it was "by no means clear," *id.*, that state law gave an effective remedy. Here, in contrast, respondents' theories depend exclusively on state law, and the Florida certification procedure unquestionably provides an effective means to determine that law. *McNeese,* moreover, explicitly recognizes that

> "Where strands of local law are woven into the case that is before the federal court, we have directed a District Court to refrain temporarily from exercising its jurisdiction until a suit could be brought in the state court," *id.*, 673,[2]

citing both constitutional and nonconstitutional cases.

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2. See C.A. Wright, Law of Federal Courts § 52, at 197 (1970) (footnote omitted). The writer explains that in *McNeese* "the Court held that in a civil rights case exhaustion of state administrative remedies is not needed, but in doing so it specifically cited the abstention cases and distinguished them on the ground that in the case before it there was no issue of state law that might be dispositive."

Finally, in *Propper* v. *Clark, supra,* a federal question case, two lower courts had agreed on their interpretation of a New York statute, and this Court held only that it was "hesitant to overrule decisions by federal courts skilled in the law of particular states unless their conclusions are shown to be unreasonable," *id.,* 486-87. The Court determined that the lower courts' view was supported by New York decisions in analogous situations and was therefore "not unreasonable," *id.,* 489. Here, in contrast, the lower courts sharply disagreed. Moreover, they could not be viewed as skilled in the law of Florida, nor can the majority position below be viewed as reasonable under Florida precedents, since it rejects principles applied by Florida courts in analogous situations. Most importantly, this Court is not called upon to "overrule" the decision below and substitute this Court's views of the law of Florida, but solely to allow an authoritative decision by a Florida court.

The concern which led this Court to reject abstention in *Propper,* moreover, has no application here. There the Court noted that in certain cases separate state law issues had been submitted to state courts, but stressed the problem of confining state court proceedings to consideration of a single issue. It noted that the state court might decide the entire case and thus "the federal court might find itself blocked by *res judicata,*" 337 U.S. at 491. Certification, in contrast, solves such problems, for it enables the federal court to send a single question to the state courts while retaining all other questions of fact and law (see Lehman Br. 61-62).

C. Respondents' own authorities support certification here.

The commentators quoted by respondents clearly do not reject certification in a case like this one. The quotation from Gowen & Izlar, *Federal Court Abstention in Diversity of Citizenship Litigation,* 43 TEXAS L. REV. 194, 209 (1964), is employed out of context in respondents' brief; in fact, the

authors endorse certification.[3] Two other sources quoted by respondents (R. Br. 25, 26) oppose only misuse of certification, which is no argument against its use in a proper case like this one.[4] Professor Wright recognizes that

3. Rather than likening certification to abstention, the authors stress in the quoted passage that the two procedures are different in principle:

> "It would not seem, however, that the certification procedure is in effect a variation of abstention. The distinction made by the Fifth Circuit in the second *Clay* opinion between abstention and certification and the effect of each appears to be sound." *Id.*, 209.

The authors point out that, unlike abstention, certification does *not* entail any compromise of the statutory grant of diversity jurisdiction, since the federal decision is governed not by the *res judicata* effect of a state judgment but by the principle of *stare decisis*:

> "In other words, since lower state courts facing the same issue presumably will follow the opinion of the state supreme court in the certified question, there is little chance that a subsequent state decision will reach a result which conflicts with the federal decision. Therefore, one of the main problems involving diversity litigation is obviated. Thus, for the certification procedure to achieve a beneficial result from the standpoint of the federal courts it is necessary that state courts be bound to follow the certified answer. The federal courts by taking advantage of a certification procedure do not abnegate their responsibility to decide a diversity case. Although a certification procedure is used, it is in the federal court that the fact determinations are made, and it is in there that the law derived from the state court in its certified answer will be applied. Therefore, the diversity plaintiff has received all to which he is entitled." *Id.*, 210.

4. The author of Mattis, *Certification of Questions of State Law: An Impractical Tool in the Hands of the Federal Courts*, 23 U. MIAMI L. REV. 717 (1969), confesses to "a strong bias against certification," *id.*, 723 and claims to see no injustice in erroneous rulings on state law: "When state and federal courts reach different conclusions as to the law who is to say which of them arrived at the 'just' result?" *Id.*, 733. Nevertheless, he concedes the propriety of certification to avoid disruption of state policies by a variant federal decision. *Id.*, 731, 733.

The author of Kaplan, *Certification of Questions from Federal Appellate Courts to the Florida Supreme Court and its Impact on the Abstention Doctrine*, 16 U. MIAMI L. REV. 413 (1962), flatly states that [a]bstention is required in . . . cases when a decision by the

"it is hard to assay the present authoritativeness of *Meredith*," C. A. Wright, LAW OF FEDERAL COURTS § 52, at 203 (1970), in light of *Thibodaux and Mashuda*,[5] and opposes only such misuse of certification as might overturn *Meredith*, which does not govern this case. More to the point, he does not question the need for abstention in instances like *Kaiser* and this case, where a federal court is asked to inject its own views of good regulatory policy into a state's jurisprudence. *Id.*, § 52, at 200 n. 34.

The refusal of the court below to certify the central issue in this case has brought forth critical comment:

> ". . . Judge Kaufman's objection to the court's method of arriving at a determination of the applicable Florida law seems well-founded. . . . Despite the fact that neither the specific cause of action recognized in *Diamond* nor its extension in *Schein* had been considered by the Florida courts, the Second Circuit nevertheless decided that Florida would have permitted a derivative suit on behalf of a corporation against third parties who traded on inside information obtained from a fiduciary. In the absence of clear precedent, a federal court might be justified in assuming that the state would adhere to the rule generally applicable in other jurisdictions. Even so cautious a rule as this, however, would not alleviate the federal court's difficult *Erie* burden.
>
> "Anticipating this type of problem, the Florida legislature enacted a statute authorizing federal appellate courts who are called upon to interpret Florida law to certify unsettled questions to the

federal courts would involve a determination of state domestic policy," *id.*, 417, and concludes that certification eliminates "some of the primary disadvantages of the abstention doctrine." *Id.*, 433.

5. *Louisiana Power & Light Co.* v. *City of Thibodaux*, 360 U.S. 25 (1959); *County of Allegheny* v. *Frank Mashuda Co.*, 360 U.S. 485 (1959).

> Florida Supreme Court." Note, *supra*, 87 HARV. L. REV. at 684-85 (footnotes omitted).

The writer concludes that certification in a case like this one provides "distinct advantages" in solving state law problems.

> "A clear decision by the highest court in the state would not only provide the most accurate determination of Florida law in the particular case, but would give both state and federal courts a precedent to rely on when the issue is presented in another case." *Id.*, 686.[6]

POINT II

No issue of waiver is presented

Rather than analyze the nature and implications of the new rule of "Florida law" announced below, respondents present the Court with a new theory of waiver, which they maintain supports a refusal to permit Florida to determine the fundamental public policy issue in this case. Thus, they point out that

> "petitioners, once confident of success and quite willing to have the Court below determine the applicable state law, have changed their view in the face of an adverse decision on the merits." (R. Br. 12).

And they repeatedly state (R. Br. 11, 12, 24, 27, 28, 30, 32, 34-37) that prior to the ruling below petitioners had not sought certification, although they sought it immediately thereafter.

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6. It should be noted that further research indicates that, in addition to the ten jurisdictions listed in our prior brief (Lehman Br. 69), the States of Minnesota and Oklahoma have adopted statutory certification procedures. MINN. STAT. ANN. § 480.061 (1973); OKLA. STAT. tit. 20 §§ 1601-13 (1973).

Respondents correctly state that petitioners were "confident of success" in the court below. It was petitioners' position below that the unusual *Diamond* doctrine was no part of Florida law, and that view has not changed. In the court below respondents presented no Florida authorities supporting a windfall recovery of insiders' trading profits by an undamaged corporation in a shareholder's derivative suit. No state other than New York had adopted such a radical deterrent device, there was not a hint in any Florida case that Florida might one day favor such a rule, much less expand it to "outside" nonfiduciaries, and in such circumstances affirmance of the District Court's dismissal seemed required.

Therefore there was no occasion for certification until after the decision below, since the law of Florida was not debatable or uncertain. The majority below, however, not only determined that the law of Florida was uncertain, but also took advantage of this supposed uncertainty in deciding to adopt an extreme minority rule as "the law of Florida". At this point the necessity for certification presented itself. Judge Kaufman so recognized and argued vigorously in dissent for certification. Petitioner likewise urged certification in its petition for rehearing. Accordingly, the claim of waiver on which respondents rely is wholly without substance.

Kaiser Steel Corp. v. *W. S. Ranch Co., supra,* presented a similar situation. There the petitioner filed a state court action in the New Mexico courts and sought rehearing before the Court of Appeals, urging abstention, only after the Tenth Circuit ruled against it on the key issue of New Mexico law. The Court of Appeals refused to abstain. On certiorari the respondent stressed that the state court

> "declaratory judgment suit raising the question was instituted and abstention requested only after the Court had rendered an adverse decision on the merits" (Brief in Opposition 2; see also *id.*, 7, 8, 18),

and labeled the petitioner's action as a "desperate, last-ditch effort" (*id.*, 8). Yet this Court, recognizing the recurrent and important nature of the public policy issue there present, and conscious that abstention also serves the public interest in sound judicial administration, put aside such arguments without discussion and ordered abstention pending state proceedings. Petitioner respectfully submits that respondents' "waiver" argument here deserves similar treatment.[7]

POINT III

There has been no exercise of discretion to which this Court may defer.

Respondents argue that the majority below declined to certify the crucial issue in this case in an exercise of discretion, to which this Court should defer. The fault in such an argument is that the majority failed to explain its refusal to certify the issue. When Judge Kaufman, in dissent, urged the majority to certify the issue so that it could be decided "authoritatively and finally" (81a), they simply ignored the point, and they did so again when the parties likewise urged certification in seeking rehearing. When a court so flatly ignores a point, it cannot be viewed as having exercised its considered judgment.

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7. Respondents attempt to support their "waiver" argument by citation of *England* v. *Louisiana State Board of Medical Examiners*, 375 U.S. 411 (1964). *England* is inapposite, since it concerns not waiver but *res judicata*, which is plainly inapplicable here, since this litigation has not concluded. Moreover, *England* holds that a litigant can request a state court not to decide a federal issue, and that such issue can later be presented to a federal court, even after judgment in the state court, and despite the fact that state and federal courts have equal authority to decide such issues. Here, in "a reverse situation" (R. Br. 34) except that the litigation is *not* concluded, petitioners request the federal courts to permit a state law issue to be determined by the state court, which has the sole authority to decide such issues conclusively. Such action is wholly in accord with *England*, which recognizes "state courts as the final expositors of state law," *id.*, 415.

The respondent in *Kaiser* similarly argued at length that the court below had properly exercised its discretion in refusing to abstain (Brief in Opposition 10-18). There, as here, the court below had completely failed to state reasons for its action, despite forceful arguments in dissent. This Court refused to defer to such unexplained action and unanimously reversed. The same action is called for in the present case.

CONCLUSION

The judgment of the Court of Appeals for the Second Circuit should be reversed and this case should be remanded with instructions to certify the controlling issue of Florida law to the Supreme Court of Florida for decision by that Court.

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